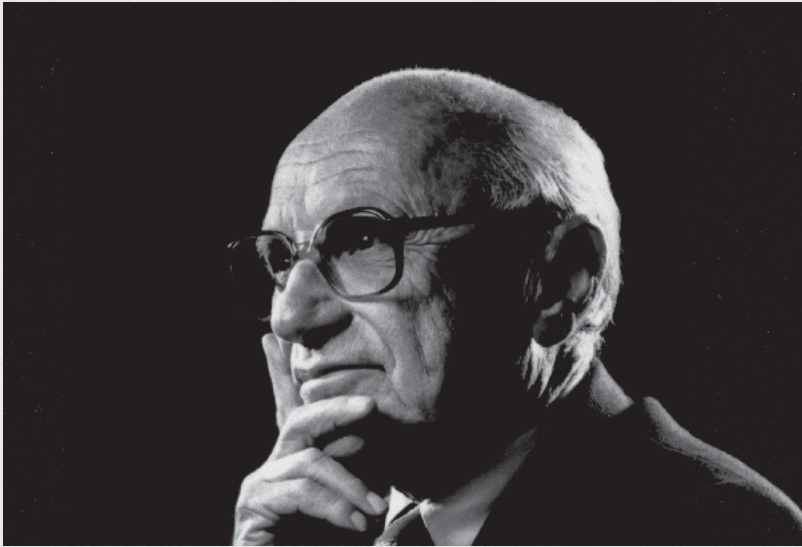


from *the* archives

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# Milton Friedman's “Mistake”: One Idea that Could Catalyze a Nation

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If there's one viewpoint that Americans all across the political spectrum share nowadays despite the pervasive polarization on most issues, it's that the federal government is wasteful, bloated, and inefficient, and that it infringes on our liberty in a wide variety of ways.

This viewpoint is reflected in polls of Republicans and Democrats, liberals and conservatives, old and young. Even well-

meaning advocates of an active federal government acknowledge that there are broad and pervasive challenges related to the current scope of government activity. They may believe in government's capacity to solve problems, but they know that the current system in Washington, D.C. is severely dysfunctional.

Nonetheless, even though most Americans acknowledge the severity of

the problem with federal spending and borrowing out of control, the national debt rising to alarming levels, and the growth in entitlements unsustainable, there does not seem to be much in the way of movement to address the problem by getting to the root of it.

As a policy wonk, I spend an inordinate amount of time in the depths of detail on the goals, impacts, and consequences (intended and unintended) of the decisions made by elected officials on a variety of issues. I get paid to pay attention. And much of the time it seems like I am alone in the wilderness.

That's disheartening in light of the daunting magnitude of the problem. Consider: For the 2014 fiscal year, total federal spending amounted to more than \$3.5 trillion. That number alone makes comprehending the challenge daunting. In the context of a \$3.5 trillion budget, millions of dollars amount to mere rounding errors, and our ability to feel vested in the scope and effectiveness of how our money is spent is almost nonexistent. It almost seems impossible to begin thinking about how to turn this massive ship in the right direction. Almost.

I have often considered one of the most brilliant market inventions of the 20th Century to be the development and implementation of casino chips. Consider—in separating gamblers from their actual cash and replacing it with colorful plastic discs, casino owners were able to gain a unique and very important psychological advantage over patrons. It's a challenge to separate a player from a crisp \$100 greenback featuring the bust of Ben

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Franklin himself; it's far easier to part with a colorful plastic disc. The cash already feels gone—it's just a matter of playing with the discs until there are no more left. The casino has won, even before you've placed a single bet.

What does this have to do with federal fiscal policy? The answer can be found in a change in the psychology of taxation dating back to 1943. There was a precedent: After the 16th Amendment was ratified in 1913 empowering Congress “to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration,” taxes were required to be withheld. That changed in 1916 when overwhelming public complaints about the system led to passage of the Income Tax Act of 1916, which eliminated the previous practice. From that point until World War II, individuals were compelled to pay their bill in total by March 15 of the following year, or apply to make quarterly installment payments on their tax bill. If you owed the federal government \$1,000 on your income from 1920, you would pay the full amount by March 15 or \$250 per quarter in 1921. The system was straightforward and for the most part, transparent.

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With America’s entry into World War II, the massive defense buildup of the 1940s created a need for more government revenues. The military needed planes, ships, guns, and bullets. The federal budget rose from about \$9 billion in 1940 to \$98 billion by 1945. The “immediate” need for revenue resulted in a law passed in 1943 called the Current Tax Payment Act.

The Current Tax Payment Act radically changed the employer/employee dynamic from that point forward. The Act compelled all employers to withhold federal income taxes from employees’ paychecks, and to remit them directly to the United States Treasury. In doing so, the federal government accomplished what casino owners would with the development of casino chips—it implemented a psychological barrier separating people who had earned wages from their money before the tax bill was officially due—and even before they had received their earned wages. In

testimony before the U.S. Congress in 1942, businessman and Chairman of the New York Federal Reserve Bank Beardsley Ruml even laid out the psychological argument behind withholding, explicitly stating that mandatory withholding by employers would “dampen taxpayer opposition.”

In a spate of irony that will not be lost on the free market-minded, the suggestion for the Current Tax Payment Act came from none other than the iconic Milton Friedman. In his 1971 work titled “Milton Friedman Unraveled,” Austrian School economist Murray Rothbard provides an analysis of the impact of Friedman’s plan:

*“Before World War II, when income tax rates were far lower than now, there was no withholding system; everyone paid his annual bill in one lump sum, on March 15. It is obvious that under this system, the Internal Revenue Service could never hope to extract the entire annual sum, at current confiscatory rates, from the mass of the working population. The whole ghastly system would have happily broken down long before this. Only the Friedmanite withholding tax has permitted the government to use every employer as an unpaid tax collector, extracting the tax quietly and silently from each paycheck.”*

In placing a buffer between individuals and the government concerning the confiscation of their earned wages for taxing purposes, the Act served as a metaphorical anesthetic—numbing taxpayers to the true impact of the earned wages they are

forced to send to the government. In the simple act of withholding smaller amounts of money from each wage earner over the course of every pay period, as opposed to compelling individuals to write a check to the U.S. Treasury, the federal government has been permitted to grow from a budget of \$9 billion in 1940 to more than \$3.5 TRILLION in 2014—an increase of 38,700 percent over the 74-year period. By contrast, U.S. GDP went from \$100 billion in 1940 to \$17.7 trillion in 2014, an increase of 17,600 percent during that same time frame.

Translation: Federal tax revenues grew by a rate more than double our economic activity. In an interview with Brian Doherty from the June 1995 issue of Reason Magazine, Friedman was asked about his involvement in introducing withholding: “I played a significant role, no question about it, in introducing withholding. I think it’s a great mistake for peacetime, but in 1941–43, all of us were concentrating on the war.

“One of the major opponents of the idea was the IRS. Because every organization knows that the only way you can do anything is the way they’ve always been doing it. This was something new, and they kept telling us how impossible it was. It was a very interesting and very challenging intellectual task.

“I was an employee at the Treasury Department. We were in a wartime situation. How do you raise the enormous amount of taxes you need for wartime? We were all in favor of cutting inflation. I wasn’t as sophisticated about how to do it then as I would be now, but there’s no doubt that one of the ways to avoid inflation was to finance

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as large a fraction of current spending with tax money as possible.

“I have no apologies for it, but I really wish we hadn’t found it necessary and I wish there were some way of abolishing withholding now.”

### **So can anything be done?**

The Current Tax Payment Act was a duly passed piece of legislation from the United States Congress and signed by President Franklin Delano Roosevelt. And thus, what the Congress passes, the Congress can certainly repeal.

Repeal the Current Tax Payment Act.

Yes, repeal it. Get rid of it entirely. Heed Milton Friedman’s plea and take us back to the glory days of tax processing prior to World War II. What would this mean? It would free up lots of time employers spend withholding, processing, and submitting income tax payments on behalf of 150 million plus workers in the U.S. It would eliminate an administrative process from employers and enable them to concentrate on the fundamental reason they are in business—to create economic activity.

More importantly, it would remove an unnecessary barrier separating individual wage earners from feeling the true impact of the tax burden they bear. If you earn

\$52,000 per year, you would receive your pay at the rate of \$1,000 per week in its entirety—right into your bank account. Subsequently, if you owe \$5,000 in income taxes (including Social Security and Medicaid contributions), you would be forced to pay that \$5,000 by either writing a check or making an online payment, just as you would any other bill you receive—directly from your own bank account.

When individuals receive a bill and make a payment on it, they are vested in the performance of that good or service. If the electricity does not work appropriately for a period of time during the month, customers will rightly expect some type of accommodation in their bill for utility services.

The same currently cannot be said about the federal government. If we repeal the Current Tax Payment Act and restore that expectation, we would see a movement of millions of people immediately more engaged in the decisions that policy makers

in Washington make with their money. I can envision the start of a crusade to demand action in how our federal government spends our money. I can imagine individuals becoming far more aware of the fact that Washington D.C.'s wasteful borrowing from our grandchildren is strangling current and future prosperity. I predict we would be far more aggressive in demanding solutions to the pressing challenges in discretionary spending, our entitlement programs, welfare programs, and our infrastructure needs.

Repeal the Current Tax Payment Act and create a catalyst for waking up millions of Americans who have been anesthetized to how bad our fiscal situation has actually become. Let hindsight not be gained in vain.

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